DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0737
Financial Institutions Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Financial Institutions Tax – Unitary Business.

Authority: IC § 6-5.5-1-18; IC § 6-5.5-2-1; IC § 6-5.5-3-1; IC § 6-5.5-5-1; IC § 6-8.1-5-1; 45 IAC 17-2-6; 45 IAC 17-3-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the exclusion of several subsidiaries from its FIT combined returns.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2; IC § 6-5.5-7-1.

Taxpayer protests the imposition of the underpayment penalty and negligence penalty.

STATEMENT OF FACTS

Taxpayer and its subsidiaries conduct the business of financial institutions, which provide various financial products, including, but not limited to, personal financial services, consumer finance, credit cards, commercial banking, private banking and corporate investment banking. Pursuant to a settlement agreement with the Indiana Department of Revenue ("Department"), Taxpayer amended its combined Indiana Financial Institution Tax (FIT) returns for tax year 2005, 2006, and 2007, subject to the Department's audit review. Upon reviewing Taxpayer's amended FIT returns for those years, the Department's audit determined that several entities, including, but not limited to, Company A (for years 2005, 2006, and 2007), Company B (for year 2006), and Company C (for years 2005 and 2006), were not transacting business within Indiana and, therefore, their income and/or losses for those years should be excluded from Taxpayer's amended combined returns, which resulted in an additional tax.

Taxpayer protests the Department's determination of removing Company A, B, and C from its combined returns. Specifically, Taxpayer believes that Company A, B, and C were transacting business within Indiana for those years and, thus, their income and/or losses should be included in Taxpayers' combined returns for those years. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Financial Institutions Tax – Unitary Business.

DISCUSSION

Pursuant to the audit, the Department determined that several entities, including, but not limited to, Company A (for years 2005, 2006, and 2007), Company B (for year 2006), and Company C (for years 2005 and 2006), were not transacting business within Indiana during those years and, therefore, their income and/or losses were excluded from Taxpayer's amended combined returns. Taxpayer, to the contrary, stated that Company A, B, and C were transacting business within Indiana and should be included in its amended combined returns.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a financial institution tax pursuant to IC § 6-5.5-2-1(a), as follows:

> There is imposed on each taxpayer a franchise tax measured by the taxpayer's adjusted gross income or apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana.

45 IAC 17-3-2(b), in relevant part, states "[i]f the taxpayer is a member of a unitary group as defined in 45 IAC 17-3-5, combined reporting is mandatory, unless IC 6-5.5-5-1(b) is applicable." IC § 6-5.5-1-18(a) further defines "unitary business" and states:

> "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana. However, **the term does not include an entity that does not transact business in Indiana**. (**Emphasis added**.)

Accordingly, only when Company A, B, and C, were transacting business within Indiana for those years, should they be included in Taxpayer's FIT combined returns.

To determine whether a taxpayer is transacting business within Indiana, IC § 6-5.5-3-1 provides:
For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:

(1) maintains an office in Indiana;
(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana.

45 IAC 17-2-6 further illustrates:

(a) A taxpayer is transacting business within Indiana if the taxpayer has activities which include any of the following:

(1) Maintains an office in Indiana by establishing a regular, continuous, and fixed place of business in this state.
(2) (A) Has an employee, representative, or independent contractor conducting business in Indiana evidenced by such persons regularly acting on behalf of the taxpayer in furthering the business of a financial institution, as defined in section 3 of this rule (45 IAC 17-2-3);
(B) both the office from which such person's activities are directed or controlled is located in Indiana and the majority of such person's services are conducted on behalf of the taxpayer in this state; or
(C) a contribution to the Indiana employment security fund is required under IC 22-4-2 with respect to compensation paid to the employee.
(3) Owns or leases to customers real or tangible personal property if the property is physically situated in this state. Mobile tangible personal property is deemed to be located in Indiana if:
(A) such property is operated entirely in Indiana or is only occasionally operated outside this state; or
(B) the principal base of operations from which the property is sent out is in Indiana or there is no principal base of operations and Indiana is the commercial domicile of the lessee or other user of the property.
(4) Regularly solicits business from potential customers in Indiana.
(5) Regularly solicits and receives deposits from Indiana customers in Indiana. Deposits are attributed to this state if they are deposits made by this state or residents, political subdivisions, or agencies and instrumentalities of this state regardless of whether the deposits are accepted or maintained by the taxpayer at locations within Indiana.
(6) Regularly sells products or services of any kind or nature to Indiana customers in Indiana that receive the product or service in Indiana.
(7) Regularly performs services outside Indiana that are consumed within Indiana.
(8) Regularly engages in transactions with Indiana customers that involve intangible property, including loans, but not property described in section 7 of this rule (45 IAC 17-2-7) and result in receipts flowing to the taxpayer from within Indiana.

(b) For purposes of this article (45 IAC 17), "regularly", when applied to any business activity, depends on the number of transactions, and with respect to any transaction, its size and complexity and whether it involves one (1) act or a series of activities to be performed over a substantial time period, and the extent to which any transaction or transactions involve the protection by the laws, government, or public institutions of the state of Indiana. The following are examples:

(1) A corporation which operates a credit card or charge card business and executes a contract with cardholders enforceable in Indiana which is evidenced by one (1) or more of the following: billed to cardholders in Indiana, providing interest on any amount due until paid, providing a card which operates as a form of money for purchasing material and services in Indiana, or establishes contracts with the Indiana vendors.
(2) A regulated financial corporation receiving deposits and making loans in Indiana, operated through mail, telephone, or automated terminals in Indiana with computer generated or other record keeping and billing outside Indiana.
(3) A regulated financial corporation providing an Indiana based corporation with a line of credit with complex credit requirements and supervision.
(4) A construction loan in Indiana requiring many draws and substantial inspection and certification over a period of time in Indiana.

Thus, in order to be considered transacting business within Indiana and to be included within Taxpayer's FIT

combined returns for those years, Taxpayer must demonstrate that Company A, B, and C met at least one of the above categories.

A. Company A (for years 2005, 2006, and 2007)

Taxpayer maintained that Company A, which served as treasury for Taxpayer and the affiliates, borrowed funds from unrelated parties and then loaned those funds at arm's-length rates to the affiliates pursuant to a Funding Agreement. The affiliates then made the funds "available to consumer lending customers including residential real estate secured loans, personal unsecured loans, auto finance loans, credit card loans, retail sales contracts, tax refund anticipation loans and insurance related products." The Department's audit determined that Company A did not meet any of eight categories outlined in IC § 6-5.5-3-1. Thus, Company A was not transacting business within Indiana for the purposes of FIT during 2005, 2006, and 2007. Taxpayer, to the contrary, claimed that Company A was transacting business within Indiana during those years pursuant to IC § 6-5.5-3-1(2), (3), (5), and/or (6).

To support its protest, in addition to a copy of a 2005 Funding Agreement between Company A (Lender) and the affiliates (Borrowers), Taxpayer provided copies of its 2006 consolidated federal return, two affiliates' Loan Licenses, letters and payments concerning renewal of Loan Licenses, as well as a list of office locations (branches) in Indiana where the affiliates were licensed to conduct business during those years. Taxpayer also submitted a copy of the Department's letter, dated July 27, 2007, stating an audit result regarding tax years 2002 through 2004 (2007 audit).

Taxpayer first asserted that, previously, the Department's 2007 audit concluded that, for FIT purposes, Company A was transacting business within Indiana in 2004. Thus, Taxpayer argued that the current audit should also follow the same determination and conclude that the same Company A was transacting business within Indiana during 2005, 2006, and 2007. However, Taxpayer's documentation demonstrated that reorganization occurred among Taxpayer and its affiliates throughout those years. Upon the execution of the Funding Agreement in 2005, Company A could have changed or modified its business operation, which was not subject to the Department's 2007 audit. Thus, Taxpayer's reliance on the Department's 2007 audit conclusion is misplaced.

Referring to IC § 6-5.5-3-1(6), Taxpayer asserted that Company A regularly engaged in transactions with two types of Indiana customers, direct customers and indirect customers. The direct customers were Company A's affiliates (or affiliate-customers) which regularly borrowed money at arm's-length rates and repaid the principal with interest according to the Funding Agreement. The indirect customers were Indiana individual residents or businesses that borrowed money from the affiliates, which were licensed to provide loan and banking services to individual residents and businesses in Indiana.

Alternatively, referring to IC § 6-5.5-3-1(2), Taxpayer claimed that the affiliates and their employees were Company A's representatives or independent contractors conducting business in Indiana. Without Company A's funding, Taxpayer claimed that the affiliates and/or their employees could not provide any loan or banking services in Indiana. Referring to IC § 6-5.5-3-1(3), Taxpayer further stated that Company A provided products or services to the affiliate-customers pursuant to the Funding Agreement. Since the affiliates-customers maintained branches in Indiana, Taxpayer thus claimed that Company A sold products or services of any kind or nature to the affiliates-customers in Indiana that received the product or service in Indiana during those years. Finally, referring to IC § 6-5.5-3-1(5), Taxpayer stated that Company A's headquarter is in Illinois and all of the activities, such as finance, treasury, and legal, occur in Illinois. Thus, Taxpayer claimed that Company A's support services were performed outside Indiana and were regularly consumed by the affiliate-customers, which were licensed lenders transacting business as financial institutions in Indiana for those years.

Taxpayer is mistaken. "Customer" is defined as "one who buys goods or services" or "a person with whom one must deal with." Webster's II New Riverside University Dictionary. Taxpayer's documentation failed to demonstrate that Company A directly provided loan or banking services to the customers in Indiana. Rather, Taxpayer's documentation demonstrated that Company A, a holding company, solely provided funding to the affiliates, which were commercially domiciled outside of Indiana but were licensed to conduct lending business in Indiana. The affiliates are Company A's customers. The transactions between Company A and the affiliate-customers, however, occurred outside of Indiana because both Company A and the affiliate-customers were commercially domiciled outside of Indiana. Upon receiving Company A's funding, the affiliate-customers then, through their Indiana branches and employees, provided the loan or banking services to Indiana customers (individual residents and businesses) based on the creditworthiness of these individuals and businesses. Therefore, Company A did not itself deal with Indiana customers and, therefore, Company A was not transacting business in Indiana pursuant to IC § 6-5.5-3-1(3) or (6). The affiliates, not Company A, were transacting business within Indiana for FIT purposes because the affiliates and their employees actually provided loan services to the Indiana customers pursuant to IC § 6-5.5-3-1(2).

Similarly, Taxpayer's documentation failed to demonstrate that IC § 6-5.5-3-1(5) is applicable because, as discussed above, the affiliates were not commercially domiciled in Indiana and, therefore, they were not Indiana residents/customers. Company A, a holding company, solely provided funding and/or services to the affiliates, which were not Indiana residents. While the affiliates maintained branches and were licensed to conduct business in Indiana, the affiliates, not Company A, provided services outside Indiana that were consumed within Indiana.

The affiliates' products and/or services provided to the Indiana customers were distinctly different from what Company A provided to the affiliate-customers.

In short, Taxpayer failed to meet its burden of proof demonstrating that Company A was transacting business within Indiana pursuant to IC § 6-5.5-3-1(2),(3),(5), or (6). Thus, the Department's audit properly removed Company A from Taxpayer's FIT combined returns for those years.

B. Company B (for year 2006)

The Department's audit determined that Company B did not meet any of eight categories outlined in IC § 6-5.5-3-1. Thus, Company B was not transacting business within Indiana for the purposes of FIT in 2006. Taxpayer stated that Corporation B, commercially domiciled in New York, provided technology related services to Taxpayer and various affiliates, which maintained branches located in Indiana during 2006. Taxpayer also provided Company B's 2006 payroll and tax withholding information to support its protest. Taxpayer's documentation demonstrated that Company B had employees conducting business in Indiana during 2006. Pursuant to IC § 6-5.5-3-1(2), Company B was transacting business within Indiana during 2006.

In short, Company B was transacting business within Indiana and should be included in Taxpayer's combined FIT returns.

C. Company C (for years 2005 and 2006)

The Department's audit determined that Company C was not transacting business within Indiana for purposes of FIT during 2005 and 2006. Taxpayer stated that Company C, commercially domiciled in Illinois, was in the business of consumer lending. Specifically, Taxpayer maintained that Company C provided financing for private label credit card programs to retailers in Indiana pursuant to credit card agreements. The retailers then offered their Indiana customers the option of financing their purchases, including sales tax, through the private label credit card programs.

Taxpayer's documentation demonstrated that Company C regularly sold products and/or services to customers in Indiana that receive the product or service in Indiana, solicited business from potential customers in Indiana, or regularly performed services outside of Indiana that were consumed in Indiana during 2005 and 2006. Thus, Company C was transacting business pursuant to IC § 6-5.5-3-1(3), (4), and (5).

In short, Company C was transacting business within Indiana for those years and should be included in Taxpayer's FIT combined returns.

FINDING

Taxpayer's protest on Company B and C is sustained, but its protest regarding Company A is respectfully denied.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

DISCUSSION

Taxpayer protests the imposition of the underpayment penalty and negligence penalty.

A. Underpayment Penalty

The Department imposed an underpayment penalty because Taxpayer failed to timely remit its payments under IC § 6-5.5-7-1.

IC § 6-5.5-7-1 states:

(a) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on a taxpayer who fails to make payments as required in IC 6-5.5-6. However, no penalty shall be assessed for a quarterly payment if the payment equals or exceeds:

(1) twenty percent (20 [percent]) of the final tax liability for the taxable year; or

(2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

(b) The penalty for an underpayment of tax on a quarterly return shall only be assessed on the difference between the actual amount paid by the taxpayer on the quarterly return and the lesser of:

(1) twenty percent (20 [percent]) of the taxpayer's final tax liability for the taxable year; or

(2) twenty-five percent (25 [percent]) of the taxpayer's final tax liability for the taxpayer's previous taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment is not appropriate.

B. Negligence Penalty

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;

(2) fails to pay the full amount of tax shown on the tax return;

(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or

(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a

taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows: The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has provided sufficient documentation to demonstrate that its failure to pay tax was not due to negligence.

FINDING

Taxpayer's protest on the underpayment and negligence penalty is sustained.

SUMMARY

Taxpayer's protest on removing Company B and C from Taxpayer's FIT combined returns is sustained. Taxpayer's protest on the underpayment and negligence penalty is also sustained. However, Taxpayer's protest on removing Company A from Taxpayer's FIT combined returns is respectfully denied.

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